DEPARTMENT OF STATE REVENUE

02-20110301.LOF

Letter of Findings Number: 02-20110301
Adjusted Gross Income Tax
For the Year 2007

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ISSUES

I. Adjusted Gross Income Tax–Settlements.

Authority: IC § 6-3-4-14; IC § 6-8.1-5-1.

Taxpayer protests that, under the terms of a settlement agreement, it is permitted to file consolidated returns even if a particular corporation is not doing business in Indiana.

II. Adjusted Gross Income Tax–Consolidated Returns.

Authority: IC § 6-3-4-14; 45 IAC 3.1-1-38; 15 U.S.C. § 381; Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992); Wabash, Inc. v. Indiana Dep't of State Revenue, 729 N.E.2d 620 (Ind. Tax Ct. 2000); Hunt Corp. v. Indiana Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999).

Taxpayer protests the exclusion of two affiliated corporations in its consolidated income tax return based on the corporations' lack of activities in Indiana.

III. Adjusted Gross Income Tax–Research Expense Credit.

Authority: IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-4; I.R.C. § 41; Treas. Reg. § 1.41-4; U.S. v. McFaddin, 570 F.3d 672 (5th Cir. 2009); Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930).

Taxpayer protests the disallowance of its research expense credit for prior years.

STATEMENT OF FACTS

Taxpayer is a corporation doing business in Indiana. Taxpayer filed a consolidated corporate income tax return on behalf of itself and two affiliated companies (collectively "Filing Group," and individually Taxpayer, Member A, and Member B). Member A was the parent company for both Taxpayer and Member B.

The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer. The Department's audit determined that Member A and Member B were not doing business in Indiana. In addition, the Department disallowed a research expense credit claimed by Taxpayer. As a result of these adjustments, the Department assessed Taxpayer additional corporate income tax. Taxpayer protested the assessment, the Department conducted an administrative hearing, and this Letter of Findings results.

I. Adjusted Gross Income Tax–Settlements.

DISCUSSION

Taxpayer protests the removal of Member A and Member B from its consolidated group for corporate income tax purposes. Taxpayer raises two separate arguments in support of its contention. First, Taxpayer argues that a prior settlement agreement requires the Department to permit Taxpayer to include Member A and Member B in its consolidated group. The language in question is from paragraph two of the prior settlement agreement.

Taxpayer was the subject of a previous audit. During the years of the previous audit period, Taxpayer filed a consolidated return under IC § 6-3-4-14 including various affiliates. The Department removed certain affiliates from Taxpayer's consolidated group. Taxpayer protested the removal of the affiliates and resulting proposed assessment of additional tax. Taxpayer argued that the affiliates had nexus with Indiana and that, in the alternative, Taxpayer should have been permitted to file a combined return. Taxpayer's protest was denied. Taxpayer then filed an appeal with the Indiana Tax Court. The resolution of the appeal was a settlement agreement which included the language cited by Taxpayer.

In the previous protest and appeal, Taxpayer and the Department referred repeatedly to the consolidated tax returns under IC § 6-3-4-14, rather than consolidated returns based on other legal or factual grounds. Further, Taxpayer's own protest of the previous assessment discussed that, if a consolidated return was not permitted under Indiana law, Taxpayer requested that its returns be treated as combined returns. Thus, based on the facts and circumstances leading to the settlement, the consolidated return language referred to a return under IC § 6-3-4-14 as opposed to an alternative filing method which may have resulted in the inclusion of companies not otherwise permitted to be in an Indiana consolidated return. Therefore, the settlement referred to Taxpayer being permitted a consolidated return under IC § 6-3-4-14, subject to the conditions set forth in IC § 6-3-4-14, rather than a consolidated return including companies that did not conduct business in Indiana.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax–Consolidated Group.

DISCUSSION

Taxpayer protests the exclusion of Member A and Member B from Filing Group. In particular, Taxpayer

argues that each of the companies should be included in Filing Group. Member A alone was removed for the 2007 tax year only. For 2003 through 2006, the Department removed Member A and Member B from the group in order to determine net operating loss carryforwards from these years to 2007. The issue is whether Member A and Member B have sufficient contacts with Indiana to permit inclusion in a consolidated return under IC § 6-3-4-14.

A consolidated return is filed on behalf of an affiliated group of corporations. Under IC § 6-3-4-14(b), "For the purposes of [IC § 6-3-4-14] the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana."

If Member A or Member B had no Indiana apportionment factors--property, payroll, and sales--then the affiliated corporation (i.e., Member A or Member B) would not be considered to be doing business in Indiana pursuant to Hunt Corp. v. Indiana Dep't of State Revenue, 709 N.E.2d 766, 781 (Ind. Tax Ct. 1999) (disallowing the inclusion of two affiliated corporations when the corporations had no Indiana property, payroll, or receipts). However, solely for purposes of discussion, it will be assumed that Member A and/or Member B had Indiana-destination sales as separate companies.

For Member A, Taxpayer directs the Department to the fact that the Member A's president was also Taxpayer's president. According to Taxpayer, the president visited Indiana's location twice a month on average and conducted various managerial duties while in Indiana. Taxpayer further notes that Member A received management fees from Taxpayer.

In support of its contention that Member A and Member B have nexus with Indiana, Taxpayer cites to Wabash, Inc. v. Indiana Dep't of State Revenue, 729 N.E.2d 620 (Ind. Tax Ct. 2000), for the proposition that the president's activities were sufficient to create nexus for Member A. In Wabash, an employee of a subsidiary performed certain services in Indiana on behalf of a corporate parent. The subsidiary filed an Indiana consolidated income tax return which included the parent corporation. The Department removed the parent corporation from the subsidiary's consolidated return. The Indiana Tax Court found that the employee's work on behalf of the parent was sufficient to create nexus for the parent corporation sufficient to permit the parent corporation to be included in the subsidiary's consolidated income tax return. Id. at 624.

In this case, Taxpayer has provided sufficient information to conclude that its president performed certain services in Indiana. However, in order for Member A to be comparable to the parent in Wabash, the president of Member A would need to be performing services in Indiana on behalf of Member A, just as the subsidiary's employee in Wabash was working in Indiana on behalf of the parent corporation. Further, based on the Department's audit report, Member A reported no Indiana payroll or other Indiana apportionment factors, which compels the conclusion that Member A did not derive adjusted gross income from Indiana sources. See Hunt, 709 N.E.2d at 781. Thus, absent some indication that Member A was working as Member A's president (as opposed to Taxpayer's), Taxpayer's protest is denied for Member A.

With regard to Member B, Taxpayer has stated that Member B's employees attend quarterly training at Taxpayer's Indiana facility. Taxpayer further asserts that all purchases by Member B from Taxpayer are approved in Indiana. Finally, Taxpayer argues that Member B's executives and employees travel to Indiana monthly to address production and product ordering issue. In addition, Taxpayer indicates that its executives and employees engage in quality review of products now located in Indiana.

For a taxpayer to be considered to be doing business in Indiana, 45 IAC 3.1-1-38 provides a list of several activities constituting "doing business in Indiana." In particular, 45 IAC 3.1-1-38(6) provides that a corporation is considered to do business in Indiana based on "Acceptance of orders in the state," while 45 IAC 3.1-1-38(7) provides that a corporation is doing business in Indiana if it is engaged in "[a]ny other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income."

P.L. 86-272, codified at 15 U.S.C. § 381, states in relevant part:

(a) Minimum standards

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

The United States Supreme Court considered the issue of what constitutes "solicitation of orders" in Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992). In Wrigley, the Court considered the scope of P.L. 86-272. Even though the Court held that the company in Wrigley was not immune from taxation in Wisconsin by virtue of certain activities, the Court noted that certain ancillary activities related to solicitation and

certain de minimis activities in a state did not cause a company to lose its immunity under P.L. 86-272. Wrigley, 505 U.S. at 232-233. The Court also noted that certain activities related to "in-state recruitment, training, and evaluation of sales representatives and its use of hotels and homes for sales-related meetings served no purpose apart from their role in facilitating solicitation" along with facilitating the resolution of a credit dispute, standing alone, did not cause the company to lose its immunity under P.L. 86-272. Wrigley, 505 U.S. at 234-235.

In this case, Taxpayer has indicated that Member B engaged in certain activities in Indiana. However, the activities in question are ancillary to the solicitation of orders. As such, P.L. 86-272 precludes Indiana from subjecting Member B to its corporate income tax, and thus Member B is not considered to be "doing business in Indiana" within the meaning of 45 IAC 3-1-1-38(7).

FINDING

Taxpayer's protest is denied.

III. Adjusted Gross Income Tax–Research Expense Credit.

DISCUSSION

Taxpayer protests the recalculation of its research expense credit. The issue is whether Taxpayer's expenses are properly computed.

Taxpayer's contentions focus on the issues of whether certain projects constitute qualified research and whether Taxpayer substantiated the related expenses.

Under IC § 6-3.1-4-1 et seq., taxpayers are permitted a credit for increasing research expenses. IC § 6-3.1-4-4 provides that federal law is "applicable to the interpretation and administration by the department of the credit provided by this chapter." Further, the key definitions relevant to the determination of the credit–"base amount" and "qualified research expense"–are determined by reference to I.R.C. § 41.

I.R.C. § 41(d) provides:

(d) Qualified research defined.--For purposes of this section--

(1) In general.--The term "qualified research" means research--

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information--

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).

Such term does not include any activity described in paragraph (4).

(2) Tests to be applied separately to each business component.--For purposes of this subsection--

(A) In general.--Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.

(B) Business component defined.--The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--

(i) held for sale, lease, or license, or

(ii) used by the taxpayer in a trade or business of the taxpayer.

(C) Special rule for production processes.--Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).

(3) Purposes for which research may qualify for credit.--For purposes of paragraph (1)(C)--

(A) In general.--Research shall be treated as conducted for a purpose described in this paragraph if it relates to–

(i) a new or improved function,

(ii) performance, or

(iii) reliability or quality.

(B) Certain purposes not qualified.--Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.

(4) Activities for which credit not allowed.--The term "qualified research" shall not include any of the following:

(A) Research after commercial production.--Any research conducted after the beginning of commercial production of the business component.

(B) Adaptation of existing business components.--Any research related to the adaptation of an existing business component to a particular customer's requirement or need.

(C) Duplication of existing business component.--Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.

(D) Surveys, studies, etc.--Any--

(i) efficiency survey,
(ii) activity relating to management function or technique,
(iii) market research, testing, or development (including advertising or promotions),
(iv) routine data collection, or
(v) routine or ordinary testing or inspection for quality control.

(E) Computer software.--Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in--
(i) an activity which constitutes qualified research (determined with regard to this subparagraph), or
(ii) a production process with respect to which the requirements of paragraph (1) are met.

(F) Foreign research.--Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

(G) Social sciences, etc.--Any research in the social sciences, arts, or humanities.

(H) Funded research.--Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Two issues are disputed by Taxpayer.

A. Research after Commercial Production and Duplication of Existing Business Components.

Taxpayer protests the disallowance of research expenses related to products already sold to customers. The issue is whether the expenses in question were for "research conducted after the beginning of commercial production of the business component" under I.R.C. § 41(d)(4)(A) or were for "duplication of existing business components" under I.R.C. § 41(d)(4)(C).

I.R.C. § 41(d)(4)(A) provides generally that research expenses for "research conducted after the beginning of commercial production of the business component" are not qualified expenses for purposes of computing the research expense credit. Treas. Reg. § 1.41-4(c) explains:

(2) Research after commercial production--(i) In general. Activities conducted after the beginning of commercial production of a business component are not qualified research. Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayer for the component's sale or use.

(ii) Certain additional activities related to the business component. The following activities are deemed to occur after the beginning of commercial production of a business component--
(A) Preproduction planning for a finished business component;
(B) Tooling-up for production;
(C) Trial production runs;
(D) Trouble shooting involving detecting faults in production equipment or processes;
(E) Accumulating data relating to production processes; and
(F) Debugging flaws in a business component.

(iii) Activities related to production process or technique. In cases involving development of both a product and a manufacturing or other commercial production process for the product, the exclusion described in section 41(d)(4)(A) and paragraphs (c)(2)(i) and (ii) of this section applies separately for the activities relating to the development of the product and the activities relating to the development of the process**. For example, even after a product meets the taxpayer's basic functional and economic requirements, activities relating to the development of the manufacturing process still may constitute qualified research, provided that the development of the process itself separately satisfies the requirements of section 41(d) and this section, and the activities are conducted before the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use.** (**Emphasis added.**)

. . .

(3) Adaptation of existing business components. Activities relating to adapting an existing business component to a particular customer's requirement or need are not qualified research. This exclusion does not apply merely because a business component is intended for a specific customer.

(4) Duplication of existing business component. Activities relating to reproducing an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component are not qualified research. This exclusion does not apply merely because the taxpayer examines an existing business component in the course of developing its own business component.

In this particular case, Taxpayer has provided information that it engaged in some qualifying research activities for the years generating the credit. In this case, the expenses related to the reproduction of a previously-developed HVAC unit or an analysis of the blueprints and design of the previously-developed HVAC unit do not qualify for the research expense credit. However, the expenses associated with developing new types of units, with developing different cabinets, and developing other designs for the purpose of developing a

technologically improved product, can be qualified research expenses. Thus, the duplication of a previously-existing product and analysis of its design does not qualify for the research expense credit; however, the design, testing, and analysis of a wholly new product can qualify. While Taxpayer has not provided specific information, the Department shall review Taxpayer's projects to determine what portion (if any) of the time and supplies expended were in fact developing new products. The Department shall apply the same standards to Taxpayer's new product development that would apply to a wholly new project (i.e., one that had not existed previously).

Taxpayer asserts that the auditor's denial of the research expense credit was improper because of the expense substantiation provided. In particular, the Department noted Taxpayer's use of estimates in determining the percentage of wages constituting "qualified research." The issue is whether Taxpayer's substantiation was sufficient.

Under IC § 6-8.1-5-4(a):

> Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

Taxpayer cites to U.S. v. McFaddin, 570 F.3d 672 (5th Cir. 2009) for the proposition that specific types of documentation are not necessarily required to substantiate a claimed expense or deduction. In particular, Taxpayer asserts that an estimate of expenses is permitted, citing the McFaddin case.

The Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930) case is particularly instructive and forms the basis of the court's decision in McFaddin. In Cohan, the taxpayer claimed various expenses on his personal income tax return. Upon audit on the taxpayer's return, the Bureau of Internal Revenue ("BIR," which was the predecessor of the current Internal Revenue Service) acknowledged that a portion of the expenses were incurred; however, the BIR disallowed all of the expenses claimed by the taxpayer. The court held that:

> Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. Cohan, 39 F.2d at 543-544.

In Taxpayer's case, Taxpayer has not provided information sufficient to conclude that any portion of Taxpayer's expenses constituted "qualified research expenses." Taxpayer has not provided the type of information used to determine what constituted a "qualified research expense." However, based on the federal case law, reasonable estimates (as opposed to exact figures) can be used to determine what constitutes a qualified research expense. However, the estimate must provide enough information to review each activity within a potentially eligible project.

Taxpayer must meet two criteria to substantiate any claimed research expenses. For employees, Taxpayer must establish the amount of time spent for each qualifying project and, if the project is partially (as opposed to wholly) exempt, must break down the time within the project by exempt and nonexempt activities. For supplies, the expenditures must be broken down by project and, as necessary, to exempt and non-exempt uses.

Taxpayer has thirty (30) days from the date this Letter of Findings is issued to provide a list of any claimed qualifying projects. Taxpayer shall also provide a description of the activities within each claimed project. Taxpayer shall also provide a breakdown (or reasonable estimate) of supply expenditures for each project and shall also provide a breakdown of employee time spent on each project, including a breakdown of time by various activities within each project. The Department shall evaluate the information provided, determine what (if any) expenses qualify for the research expense credit, and adjust the research expense credit and Taxpayer's Indiana corporate income tax liability accordingly.

FINDING

Taxpayer's protest is sustained subject to audit verification.

CONCLUSION

Taxpayer's protest is denied except with regard to the research expense credit. Taxpayer's protest of the research expense credit redetermination is sustained subject to audit verification.

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